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Auditor Settlements of Securities Class Actions

*James J. Park**

Some corporate law scholars have concluded that auditors do not have sufficient legal incentive to detect securities fraud and should be governed by a strict liability standard. This study assesses this argument by examining a dataset of 554 class actions alleging an accounting restatement filed from 1996 through 2007. Because some but not all of these restatement cases named an auditor defendant, it is possible to analyze whether variables such as the liability standard affect both the decision to name an auditor defendant as well as the outcome of the case. Despite the narrowing of auditor liability under Rule 10b-5, auditors are still often named as defendants and pay substantial settlements in Rule 10b-5 cases. A more restrictive liability standard is associated with a modest reduction in the rate at which auditors are named as defendants and the rate at which auditor cases end in settlement. If a Rule 10b-5 case against an auditor is strong enough to result in a settlement, the legal standard does not affect the size of the settlement. The auditor's payment is correlated with nonlegal factors such as whether the issuer is bankrupt and the issuer's market capitalization. These results are best explained by the tendency of judges to read narrow liability provisions broadly in cases where the size and impact of the alleged fraud are significant. The evidence thus does not support the conclusion that a strict liability standard is necessary to generate sufficient incentives for auditors to detect substantial frauds.

I. Introduction

Because of the critical role of a company's financial statements in valuing its securities, auditors serve as a critical gatekeeper to the capital markets. The federal securities laws thus make auditors liable to purchasers of securities in certain circumstances when a company commits securities fraud under the auditor's watch. From the late 1990s to the mid-2000s, an epidemic of accounting fraud at major public companies led many commentators to question why auditors had not detected such misconduct.

One explanation was that Congress and the courts had shielded auditors from private litigation under the securities laws, reducing the incentive of auditors to carefully

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audit public companies. First, in its 1994 *Central Bank v. First Interstate Bank* decision,[1] the U.S. Supreme Court ruled that secondary actors such as auditors could not be liable for aiding and abetting under SEC Rule 10b-5, the most widely used cause of action for securities fraud. Instead, the plaintiff must show that the auditor was a primary violator of the law, a difficult task because an auditor is rarely the main architect of a fraud. Second, in 1995, the Private Securities Litigation Reform Act (PSLRA), which was heavily supported by the auditing industry, made it more difficult to successfully bring claims under Rule 10b-5. Among other reforms, after the PSLRA, plaintiffs have a greater burden to establish a strong inference of fraudulent intent at an early stage of the lawsuit. The courts have made establishing such intent especially difficult with respect to an auditor defendant.

These developments prompted a leading commentator to note that "auditors ... have been well insulated against securities fraud liability" (Coffee 2006:1550). Writing soon after the Enron and WorldCom scandals, several corporate law scholars independently concluded that auditors should be governed by a strict liability standard (Partnoy 2001; Hamdani 2003; Coffee 2004). At the time of these proposals, there was little significant data on securities class actions filed against auditors after the liability shielding efforts of the mid-1990s.[2]

A later strand of the literature has documented that auditors continue to pay significant amounts to resolve securities class actions. In studying the possibility that an auditor could be subject to catastrophic liability, scholars have noted that auditors continue to be defendants in securities class actions and pay significant settlements (Talley 2006; Donelson 2013). Another study finds 144 auditor settlements in cases filed from 1996 to 2005, and that such settlements are more likely in securities class actions involving an accounting restatement (Donelson & Prentice 2012).

Though some scholars have used theory to analyze the legal standard governing auditors, and others have studied cases imposing significant auditor liability, no study has closely examined how restrictions on the scope of liability affect the resolution of securities class actions against auditors. This study analyzes a dataset of 554 securities class actions involving restatements filed from 1996 to 2007, and finds that some liability restrictions are associated with a modest reduction in the rate at which auditors are named as defendants and the rate at which auditor defendants contribute to a settlement. However, once a case settles, the size of that settlement is not affected by the legal standard.

In coming to these conclusions, this study exploits two differences in the way securities class actions are resolved in assessing the impact of more restrictive auditor liability standards. First, with respect to the elimination of aiding and abetting liability, some circuits retained a test with a close resemblance to the old aiding and abetting test. Most notably, the Ninth Circuit considered an auditor to be a primary participant when it

[1]511 U.S. 164 (1994).

[2]For example, one of the articles lists six examples of auditor settlements during this time period (Coffee 2004:341), and another article noted that "settlement value of cases against auditors has gone way down" (Coffee 2002:1410).

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provides "substantial assistance" with respect to a fraudulent statement. The Second Circuit has been more faithful to *Central Bank*'s decision by considering an auditor to be a primary participant only for statements that are directly made by the auditor. Second, while Rule 10b-5 requires proof of scienter, many cases against auditors are also brought under Section 11 of the Securities Act of 1933, which does not have such a requirement. By comparing cases governed by the broader liability standard with those governed by the narrower liability standard, inferences can be made about the impact of a more protective liability standard.

An initial look at the data shows that auditor settlements have an outsized presence in the cases involving the most substantial frauds. Auditors contributed to almost half of the largest 100 settlements for securities class actions filed from 1996 to 2007, with an average auditor payment of $60 million. About half these cases asserted claims solely under Rule 10b-5. Thus, the liability narrowing efforts of the mid-1990s allowed for significant auditor liability in connection with a particular type of case, those involving the most severe frauds.

The study then examined all the securities class actions filed from 1996 to 2007 where the issuer admitted an error in its financial statements through a restatement. Because a restatement is an admission of a material misstatement in the company's financial statements, most of the significant auditor settlements should be captured by this sample. Because not all cases with a restatement result in an auditor settlement, or even an auditor being named as a defendant, study of this restatements sample can reveal how differences in legal standards influence different aspects of auditor litigation.

The study models two different stages of a securities class action involving a restatement. In the first, the plaintiff determines whether an auditor will be named as a defendant. In the second, the parties and court will determine whether the case will settle, as well as the size of the settlement. The first decision is modeled with a logit regression, with the naming of an auditor defendant as the dependent variable. The second is modeled with a hurdle regression, which first models the decision to settle a case against an auditor, and then for those cases that settle, models the determinants of the size of the auditor settlement.

The results of this analysis reveal that narrower legal standards have not uniformly protected auditors from liability. The standard for primary liability does not affect the rates at which auditors are named as defendants or settle cases when they are named. In contrast, the auditor scienter standard is correlated with a modest reduction the likelihood that an auditor will be named as a defendant and the likelihood that an auditor defendant will contribute to the settlement.

However, the auditor scienter standard does not appear to affect the size of the auditor settlement. When an auditor settles a case, the narrower liability standard does not appear to be a factor in determining how much it should pay. Two nonlegal factors that are proxies for the severity of a fraud, whether the issuer was in bankruptcy and the market capitalization of the issuer, are major determinants of the size of the auditor settlement. If a Rule 10b-5 case involving a restatement is strong enough to name an auditor defendant, and the case against the auditor is strong enough to survive dismissal, the auditor is likely to settle for a similar amount as it would in a case governed by the more lenient standard of Section 11. Thus, stricter legal standards screen cases without precluding liability for many cases with merit.

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The study concludes by looking to the case law in explaining these results. There is evidence that judges read liability standards differently when they perceive that a case has merit and involves a significant fraud. Indeed, in one unusual case, *Global Crossing*, a district court in the Second Circuit essentially refused to apply that circuit's stringent attribution test to dismiss the auditor from the case. Also, soon after the wave of securities fraud beginning in the late 1990s, some courts developed doctrine that makes it easier to find that an auditor acted with scienter in cases involving substantial accounting fraud by the issuer. The willingness of courts to loosen restrictive liability standards in this way may influence the parties to settle auditor cases involving severe frauds for sizeable amounts.

These findings are significant for a number of issues raised by the literature. First, they counter the pessimistic prediction by some scholars that judges use heuristics to reflexively dismiss securities class actions because they are hostile to such cases. Second, the results cast doubt on whether a strict liability standard is necessary to deter auditor fraud. The auditor scienter standard somewhat reduces the rate of auditor settlements, but courts have not permitted auditors to escape liability for many substantial frauds. Third, these results may support additional limitations on Rule 10b-5 for nonauditor defendants. Narrowing the general reach of Rule 10b-5 could reduce the number of settlements in cases with marginal merit while allowing liability for the most serious frauds.

The next section describes the different securities fraud liability standards governing auditors. Section III describes prior studies. Section IV describes the data. Section V analyzes the data. Section VI argues that the study's results are best explained by the tendency of courts to loosen what seem to be narrow liability rules in response to significant frauds. Section VII concludes.

II. Two Liability Standards for Auditors

In creating rules for auditor liability, Congress and the courts have balanced two considerations.[3] On the one hand, auditors are an important gatekeeper because a company cannot access public markets without an auditor's approval. Law can provide additional incentives for auditors to help keep fraudulent companies from deceiving public investors. On the other hand, auditors should not be essentially insurers of fraud (Goldberg 1988). Because auditors cannot detect every fraud, it is unfair to hold them responsible whenever a client misstates its financials. Reasonable limits on auditor liability should balance these concerns about the proper role of the auditor (Kraakman 1984).

The contrast between the gate-keeping and insurance arguments can be seen in the two different ways in which auditors can be liable for securities fraud. The first is when there is a material misstatement in the financial statements of an issuer selling securities to the public. Reflecting a gate-keeping approach, the law allows for auditor liability even without a showing of fraudulent intent. The second is when there is a

[3]Auditors can also be subject to suit under state law, but in 1998, Congress preempted state securities class actions. See Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. 105-353, 112 Stat. 3227.

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material misstatement in the financial statements included in the issuer's periodic disclosures. Reflecting concerns about making auditors insurers, liability for this broader category of fraud requires showing that the auditor was (1) a primary participant with respect to the fraud and (2) acted with fraudulent intent.

A. Auditors as Gatekeepers: Section 11 Liability

Section 11 of the Securities Act of 1933 makes various parties, including "every accountant," liable for material misrepresentations in an issuer's registration statement, which must be filed before securities are sold in an offering to the public. This liability applies even if the misstatement is completely unintentional. In imposing liability for material misstatements, Section 11 not only deters companies from committing fraud when selling securities, it creates incentives for gatekeepers who are retained by an issuer to verify the truth of its disclosures.

Unlike the issuer, secondary actors such as auditors can escape liability under Section 11 by establishing a due diligence defense. To win a due diligence defense, the auditor must show "after reasonable investigation, [it] had reasonable ground to believe and did believe" that the financial statements at issue were correct.[4] An auditor might satisfy this standard by showing that it performed a proper audit of the issuer.

Though it is a substantial defense to Section 11 liability, the due diligence defense has not precluded auditor settlements of securities class actions. As the district court that decided the *WorldCom* case noted, "[t]here is limited guidance in the case law as to the contours generally of the due diligence defense under Section 11" and even "less commentary on the application of the defense to accountants."[5] Given the lack of clear guidance, and the fact that it is an affirmative defense, it is difficult to establish that an auditor acted with due diligence at an early stage of the case.[6] If a case cannot be dismissed prior to trial, a risk-averse auditing firm will most likely choose to avoid such a trial by settling the case. Thus, when there is a material misstatement in the financial statements included in a registration statement, auditors can have significant incentives to settle claims brought under Section 11.

B. Auditors are Not Insurers: Limiting Auditor Liability Under Rule 10b-5

Like other possible defendants, auditors have greater protection from liability for misstatements contained in financial statements that are not associated with a securities offering. SEC Rule 10b-5 makes it unlawful to commit fraud "in connection with the

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[4]Securities Act of 1933, at § 11(b)(3)(B).

[5]In re WorldCom, Inc., Sec. Litig., 352 F. Supp.2d 472, 492 (S.D.N.Y. 2005).

[6]See, e.g., Feyko v. Yuhe Int'l, Inc., No. CV 11-05511, 2013 WL 816409, at *8 (C.D. Cal. Mar. 5, 2013) (noting that due diligence affirmative defense can be granted only if it is clear from the complaint that the auditor acted reasonably); In re Wachovia Equity Sec. Litig., 753 F. Supp.2d 326, 379 (S.D.N.Y. 2011) (finding that "[a]lthough KPMG may ultimately avoid Section 11 liability ... due diligence is an affirmative defense and therefore unavailable on a motion to dismiss").

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purchase or sale of any security." Because it is not restricted to misstatements relating to the registration statement, Rule 10b-5 can apply to fraud involving periodic reporting of financial reports, whether they are in formal SEC filings such as a 10-K or 10-Q, or less formal documents such as press releases disseminated to investors. Thus, Rule 10b-5 has a much broader reach than Section 11, raising greater concerns that without limits it could essentially make auditors insurers of fraud.

Unlike Section 11, the scope of Rule 10b-5 liability is not as explicitly spelled out by the text of the rule. Over the years, the federal courts have used common-law decision making to develop standards defining the scope of secondary actors such as auditors. The first such legal standard relates to when auditors can be considered a primary violator of Rule 10b-5 for failing to detect fraud by an issuer. The second legal standard relates to whether an auditor has acted with the requisite fraudulent intent.

1. Primary Liability for Securities Fraud

As noted earlier, for decades, auditors could be found liable under Rule 10b-5 for aiding and abetting a securities fraud. Put another way, even if the auditor was not the primary actor that committed the fraud, it could be liable as a secondary actor that provided assistance with respect to the fraud. In making this determination, courts generally applied a three-part test that looked at (1) whether there was a violation of the securities law by the primary party; (2) whether the aider and abettor knew of the violation; and (3) whether the aider and abettor gave "substantial assistance" with respect to the primary violation.[7]

In its 1994 *Central Bank* decision, the U.S. Supreme Court reversed the law developed by lower courts and held that Rule 10b-5 liability could not be imposed on a party simply for aiding and abetting a securities fraud. Looking at Section 10(b) of the Securities Exchange Act, the Court found that its text did not support imposing liability on secondary actors such as auditors. Moreover, the Court observed that there are substantial costs associated with aiding and abetting liability. However, the Court did not completely foreclose the possibility of auditor liability under Rule 10b-5. It instead said that gatekeepers such as auditors can still be liable if they are primary participants in the securities fraud.[8]

The test for imposing primary liability on auditors was left unclear by *Central Bank*. The case did not provide a test for determining whether an actor was a primary or secondary actor with respect to the fraud. In light of the ambiguity left by *Central Bank*, the courts of appeal developed different tests for assessing whether an auditor can be liable under Rule 10b-5 for a misstatement by an issuer (Fisch 1999:1318). The courts have utilized two major approaches.[9] The Second Circuit developed a more restrictive approach while the Ninth Circuit developed a liberal approach.

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[7]See IIT v. Cornfeld, 619 F.2d 909, 922 (2d Cir. 1980) (Friendly, J.).

[8]*Central Bank*, 511 U.S. at 191.

[9]See, e.g., In re Lernout & Hauspie Sec. Litig., 230 F. Supp.2d 152, 161–62 (D. Mass. 2002) (describing two approaches to "determining when independent auditors have primarily liability"); In re Enron Corp. Sec., Deriv. & ERISA, 235 F. Supp.2d 549, 583–85 (S.D. Tex. 2000) (same).

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In the Second Circuit, an auditor can be liable as a primary violator of Rule 10b-5 only for a misrepresentation that was "made" or that can be "attributed to" the auditor.[10] This article will refer to this rule as the "attribution" standard.[11] Under an attribution standard, it is insufficient to allege that the auditor "assist[ed]" or "participat[ed] in" the securities fraud.[12] The auditor must directly make a statement that is incorrect and relied on by investors. Thus, an audited financial report included in an annual 10-K could give rise to liability because the auditor signs an explicit statement that it has audited the company's 10-K financials. In contrast, quarterly 10-Q filings and other announcements are not subject to an audit, and thus would not involve statements "made" by the auditor.[13] An auditor might review those financial statements, but will not do a formal audit that results in a signed statement vouching for their validity.

In contrast to the Second Circuit, the Ninth Circuit has applied a "substantial participation" test, which does not require the auditor to make a statement to investors for Rule 10b-5 liability to attach.[14] Such participation is not limited to a formal audit, but can encompass "creation, drafting, editing, or making of statements."[15] Thus, in the Ninth Circuit, unlike in the Second Circuit, an auditor could be liable for unaudited financial statements in the issuer's 10-Q. Or, an auditor who gives an issuer advice about a press release could be responsible for misstatements later found in that release. This "substantial participation" test is obviously similar to the prior "substantial assistance" test for aiding and abetting liability.

The Second and Ninth Circuits have applied their different tests to auditor liability for many years. However, the Ninth Circuit's approach is likely no longer good law. In 2011, the Supreme Court decided a case, *Janus Capital Group, Inc. v. First Derivative Traders*,[16] with significant implications for auditor liability. In *Janus*, the Court held that only the actual "maker" of a misrepresentation can be liable under Rule 10b-5. According to the Court, "the maker of a statement is the person or entity with ultimate

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[10]See, e.g., Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998); Shapiro v. Cantor, 123 F.3d 717, 720–21 (2d Cir. 1997).

[11]A number of other circuits, such as the Tenth and Eleventh, have adopted an attribution test similar to that of the Second Circuit. See, e.g., Ziemba v. Cascade Int'l Inc., 256 F.3d 1194, 1205 (11th Cir. 2001); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226–27 (10th Cir. 1996); see also Danis v. USN Comm., Inc., 121 F. Supp.2d 1183, 1193 (N.D. Ill. 2000) (dismissing claims against auditor relating to unaudited financial statements).

[12]*Shapiro*, 123 F.3d at 720–21.

[13]See, e.g., Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147, 154 (2d Cir. 2007); In re Warnaco Group, Inc. Sec. Litig. (II), 388 F. Supp.2d 307, 313–14 (S.D.N.Y. 2005).

[14]See, e.g., In re Software Toolworks Inc., 50 F.3d 615, 628 n.3 (9th Cir. 1994); In re Homestore.com, Inc. Sec. Litig., 347 F. Supp.2d 790, 800 (C.D. Cal, 2004).

[15]*In re Homestore.com, Inc.*, 247 F. Supp.2d at 800.

[16]131 S. Ct. 2296 (2011).

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authority over the statement, including its content and whether and how to communicate it."[17] Even a party who drafted the content of the statements made by the actual "maker" of a misrepresentation is not considered to be a primary violator. Thus, in *Janus*, an investment advisor was not a primary violator of 10b-5 with respect to statements that were issued under the name of an investment company, even though the investment advisor drafted those statements.

While it did not involve an auditor, it is difficult to see how the Ninth Circuit's "substantial participation" test will be consistent with the Supreme Court's interpretation of Rule 10b-5 in *Janus*. Indeed, the Court explicitly stated that Rule 10b-5 suits "against entities that contribute 'substantial assistance' to the making of a statement but do not actually make it—may be brought by the SEC … but not by private parties."[18] A number of commentators have observed that *Janus* will make it more difficult to hold auditors liable as primary participants in Rule 10b-5 cases (Consenza 2012:1082–83; Jeffries 2013:493; Steinberg 2014:611–12). The Ninth Circuit has not yet explicitly held in a case involving an auditor that the substantial participation standard has been overruled, but it has noted in other contexts that *Janus* must be read as requiring attribution.[19] With *Janus*, the test for whether an auditor can be a primary violator of Rule 10b-5 is likely to become even more restrictive.

2. Scienter

In addition to establishing that the auditor was a primary participant in the fraud, for there to be a claim under Rule 10b-5, the plaintiff must show that the auditor acted with fraudulent intent. This requirement makes claims for secondary market fraud more difficult to establish than claims under Section 11, which does not require any showing of intent. For any party, such intent, often referred to as scienter, requires more than a showing of negligence or carelessness.[20] Federal courts thus generally apply a recklessness standard in Rule 10b-5 cases.

Courts may be especially reluctant to find that auditors acted with scienter because auditors themselves are often the victims of fraud. Insiders of the corporation have greater access to information than auditors and will often keep auditors in the dark about the fraud. As one court observed, "a strong inference of scienter by an outside auditor is difficult because outsider auditors have more limited information than, for example, the company executives who oversee the audit."[21] Indeed, auditors typically do not have direct financial incentive to allow fraud. As one court noted, "[u]nlike the

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[17]Id. at 2302.

[18]Id.

[19]See, e.g., Reese v. BP Exploration (Alaska) Inc., 643 F.3d 681, 693–94 n.8 (9th Cir. 2011) (observing that *Janus* "sets the pleading bar even higher in private securities fraud actions seeking to hold defendants primarily liable for the misstatements of others," and that defendant was not alleged to have "ultimate authority" over filings).

[20]See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[21]New Mexico State Inv. Council v. Ernst & Young LLP, 641 F.3d 1089, 1097 (9th Cir. 2011).

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officers and directors of the companies it represents, an independent accountant has no ability to line its pockets through insider trading, and no incentive to cover up corporate mismanagement."[22] To the extent that audits miss evidence of fraud that is later disclosed, the reputation of the auditor will suffer, thus auditors should have significant incentive to prevent frauds even without the possibility of a damages award.

On the other hand, auditors can have an incentive to turn a blind eye to misconduct by insiders. An auditor may not be a direct participant in the fraud, but may ignore it in order to keep an important client. As one court observed: "A few top auditing firms compete for high-profile clients ... they have strong structural incentives to yield to management on close questions."[23] Prior to the passage of the Sarbanes-Oxley Act, which prohibits consulting by auditors, a number of courts observed that auditors might defer to company managers for fear of losing consulting business.[24]

Because auditors have fewer incentives than issuers to commit fraud, courts have described the standard for finding an auditor acted with scienter as even higher than the standard with respect to other parties.[25] The Second Circuit has described the recklessness standard for accountants as "conduct that is 'highly unreasonable', representing 'an extreme departure from the standards of ordinary care.' It must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company."[26] Simply allowing the "publication of inaccurate accounting figures, or a failure to follow GAAP," by itself is insufficient.[27] The Ninth Circuit has an equally stringent formulation, requiring that "the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts."[28]

In applying the auditor scienter standard, courts often focus on the existence of "red flags" in determining whether auditors acted with scienter. As the Ninth Circuit explained: "In examining allegations of scienter, courts have looked at a range of factors for potential 'red flags,' ... the more facts alleged that should cause a reasonable auditor to investigate further before making a representation, the more cogent and

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[22]Reiger v. Price Waterhouse Coopers LLP, 117 F. Supp.2d 1003, 1007–08 (S.D. Cal. 2000).

[23]In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp.2d 1132, 1197 n.79 (C.D. Cal. 2008).

[24]See, e.g., *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp.2d at 675–76.

[25]See, e.g., PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (6th Cir. 2004) ("the meaning of recklessness is especially stringent when the claim is brought against an outside auditor").

[26]Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000).

[27]In re Software Toolworks Inc., 50 F.3d 615, 627–28 (9th Cir. 1994).

[28]Id.

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compelling a scienter inference becomes."[29] Courts in the Second Circuit follow a similar approach.[30] While the requirement of pointing to particular red flags is a substantial barrier to auditor liability, it may leave open a way for plaintiffs to establish scienter.

Finally, as noted earlier, the PSLRA gives courts the tools necessary to dismiss cases against auditors and other defendants at an early stage. The plaintiff has the burden of pleading sufficient facts in the complaint so a court can conclude there is a "strong inference" of scienter. Coupled with the especially stringent substantive standard of auditor scienter, the PSLRA appears to provide auditors with ample protection from Rule 10b-5 suits.

3. Proposals to Reform Auditor Liability Under Rule 10b-5

Around the time of the stunning collapse of companies such as WorldCom and Enron in the wake of accounting fraud, a number of prominent academics examined the proper liability standard for gatekeepers such as auditors. Prior efforts to protect auditors from liability under Rule 10b-5 were seen as a reason why auditors failed to prevent a major wave of accounting fraud. Commentators were concerned that the liability standard was too stringent and argued that it should be relaxed.

Three major articles proposed a strict liability standard for auditor securities fraud liability. Both Professors Partnoy and Coffee concluded that the best system would be strict liability with some limits on the total extent of such liability.[31] Professor Hamdani also argued that auditors should be subject to strict liability under Rule 10b-5 for financial statement fraud, though they could raise a due diligence defense similar to the one permitted by Section 11. While arguing that a knowledge standard might be optimal for other gatekeepers, he argued that "the auditor-certification rule would overcome the shortcomings of the scienter standard" and "provide at least one capital-market participant with the incentives to scrutinize public-company disclosure" (Hamdani 2003:118).

Though these three proposals come from different perspectives, they all concluded that the barriers to liability under Rule 10b-5 for gatekeepers are too demanding.[32] Moreover, their approach is similar in applying economic theory to the particular problem of auditor liability (though their conclusions were also likely influenced by the wave of accounting fraud occurring at the time). There are limits to this approach. Although many securities class actions were filed against auditors after the collapse of Enron and WorldCom, most of these cases had not been resolved at the time of the initial wave of scholarship on auditor liability. Thus, while scholars could assess the law on the books,

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[29]New Mexico State Inv. Council v. Ernst & Young LLP, 641 F.3d 1089, 1097–98 (9th Cir. 2011).

[30]See, e.g., In re AOL Time Warner, Inc., 381 F. Supp.2d 192, 240 (S.D.N.Y. 2004).

[31]Partnoy proposed that auditors be able to limit damages through contracting with the issuer (Partnoy 2001:492). Coffee argued for a cap based on a multiple of the auditor's revenue from the issuer (Coffee 2004:350).

[32]Not all scholars have proposed lowering the standard of liability (Pritchard 2006).

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they were not able to fully assess how courts actually applied the law to auditors. Studying the many cases that were resolved after these proposals can shed more light on the impact of the efforts to narrow liability under Rule 10b-5.

III. Literature Review

This section reviews prior empirical studies of auditor liability for securities fraud. About half these studies looked at the period prior to *Central Bank* and the PSLRA. A number of studies examined auditor settlements after passage of the PSLRA, but they did not extensively test the impact of legal doctrines on both the decision to name an auditor defendant and the decision to settle auditor cases.

Early studies of auditor litigation focused on a broader range of cases than securities class actions. For example, one study examined 472 cases against auditors from 1960–1985 (Palmrose 1988). It found that smaller auditing firms were sued at higher rates than the "Big Eight" accounting firms, implying that smaller firms performed lower-quality audits. A 1994 study examined the relationship between a client's bankruptcy and auditor litigation (Carcello & Palmrose 1994). It covered 655 public companies with a "Big Six" auditor that filed for bankruptcy between 1972 and 1992. The study found that auditors were sued at a higher rate with respect to bankrupt clients (18 percent) than with respect to clients that did not file for bankruptcy (3 percent). The study found that auditor litigation ended in dismissal 33 percent of the time, and that the average settlement was $7.5 million.

Shortly prior to the passage of the PSLRA, a number of studies looked at securities class actions against auditors. One study examined 476 securities class actions involving financial disclosure from April 1992 to April 1995 (Fuerman 1997). It found that 86 of those cases had an auditor defendant. A logit regression showed that auditors were more likely to be named in securities class actions when there was SEC enforcement against the auditor or one of the managers, the issuer was bankrupt, or when there was an accounting restatement. Another pre-PSLRA study presented evidence on the size of auditor settlements of securities class actions (Marino & Marino 1994). From April 1989 through February 1994, there were 127 cases where an auditor was named as a defendant in a federal or state securities class action; 106 of those cases resulted in auditor settlements. The mean settlement was $9.64 million and the median settlement was $2.03 million.[33] The study found that bankruptcy and the presence of "flagrant fraud" were associated with larger auditor settlements.

A few studies presented statistics on auditor settlements after the passage of the PSLRA. Two studies looked at past auditor settlements in order to project the risk an auditor would be subject to catastrophic liability. Talley collected data on 2,016 securities class actions filed from 1994 to 2005 (Talley 2006). He found that a Big Five auditor was named in 6.55 percent of the cases, and that the cases ended in dismissal 16 percent

[33]Another pre-PSLRA study came to similar results, finding that the mean of auditor settlements was $11 million with a median settlement of $5 million (Carleton et al. 1996).

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of the time. The average auditor settlement during that period was $13 million. In a later study, Donelson looked at aggregate settlement numbers for a similar time period, 1996 to 2007, finding a total of $1.733 billion in auditor settlements to resolve federal securities class actions (Donelson 2013). He presented summary statistics, noting that in Rule 10b-5 cases, auditor payments were equal to 23.5 percent of the total settlement, while auditor payments were equal to 4.2 percent of Section 11 settlements. Both studies primarily focused on constructing models to estimate the probability that an auditor would be subject to catastrophic liability.

The most comprehensive recent study of auditor settlements is by Donelson and Prentice. They examined cases filed from 1996 to 2005 asserting Rule 10b-5 claims that were resolved by December 2011. They focused on a total of 144 cases where auditors were named as defendants. They estimated logit regressions that modeled whether the case ended in an auditor settlement, as well as whether the auditor settlement was above $5 million. Consistent with prior studies, they reported that restatements, high audit fees, and SEC enforcement are statistically significant independent variables affecting the likelihood of an auditor settlement.

Though there is some overlap between this article and the Donelson and Prentice paper, the two studies test different hypotheses. Donelson and Prentice focus on whether the presence of various factual red flags relating to accounting fraud predict whether courts will conclude an auditor acted with scienter (Donelson & Prentice 2012:480). They find that they do not, and thus conclude that the law's vagueness makes it impossible to assess the merit of securities class actions against auditors. A possible response to this conclusion is that courts tend to assess liability holistically by weighing a number of different factual considerations. Thus, it may not be possible to identify particular red flags that will consistently be associated with case outcomes.

Rather than focusing on the presence of particular facts, this study looks at legal standards.[34] Thus, it tests whether the different primary liability rules in the Second and Ninth Circuit, as well as the difference between Section 11 and Rule 10b-5 cases, impact auditor settlements. Moreover, this study goes beyond Donelson and Prentice by studying the decision to name an auditor as a defendant. The Donelson and Prentice study is limited to dismissal and settlement decisions with respect to 144 cases where an auditor is named as a defendant. Legal standards may have an impact not just with respect to whether a case settles, but also on the prior decision of whether an auditor is named as a defendant in the case. This study thus begins with a larger sample of 554 restatement cases, which allows modeling of the process by which plaintiffs choose to sue an auditor.

[34]Other studies have examined changes in legal standards for securities class actions generally. For example, Professors Choi and Pritchard find evidence that the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* led to lower dismissal rates in circuits that had applied a higher pleading standard prior to the case (Choi & Pritchard 2011).

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IV. Data

A. Samples

The cases for this study were identified from a dataset of securities class actions filed from 1996 through 2007, a total of 1,885 cases. The dataset was limited to cases where the primary allegation was that shareholders purchased stock inflated by securities fraud.

To test the intuition that auditors might be more likely to be liable for severe frauds, all the cases that ended in settlement were ordered by the size of settlement, and the 200 largest settlements from the dataset were identified (the "Largest 200 Settlements" sample).[35] These settlements include the high-profile cases against Enron, WorldCom, Tyco, Cendant, AOL Time Warner, and AIG.

Then, all the cases in the dataset where the issuer restated its financial statements were identified, a total of 554 cases (the "Restatement" sample). This Restatement sample is the primary subject of this article's analysis. Because many securities class actions do not raise an accounting issue, the analysis is facilitated by focusing on a set of cases that are alike in that they involve an accounting restatement that could be a basis for naming an auditor as a defendant. Because not all Restatement cases result in the naming of an auditor defendant, examination of this sample allows for analysis of the legal and nonlegal factors that influence whether an auditor is named as a defendant as well as the outcome of the case.

B. Descriptive Statistics

1. The Largest 200 Settlements

Despite efforts by the courts to insulate auditors from securities fraud liability, close to a third of the Largest 200 Settlements had an auditor contribution to the total settlement. This is a much higher rate than for all securities class actions, where auditors were named as defendants less than 10 percent of the time.[36]

These auditor settlements were concentrated in the top half of the Largest 200 settlements. As Figure 1 shows, almost half of these 100 settlements had an auditor contribution, averaging about $60 million. This average settlement amount is much higher than the average settlement of about $10 million for the broader range of auditor settlements reported by prior studies.[37] Table A2 of the Appendix lists more than 10 such settlements where the auditor contributed more than $100 million to the settlement. An auditor settlement of $100 million by itself would be enough to qualify as one of the 100

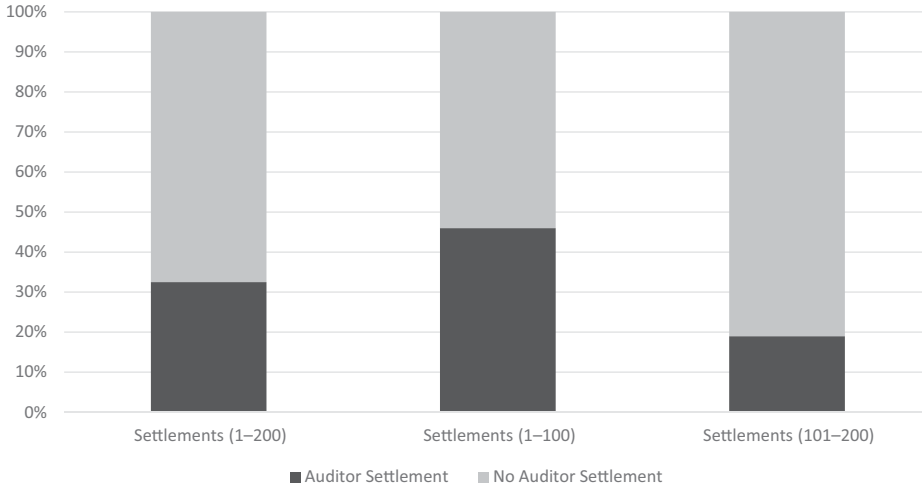
[35]A total of 1,187 securities class actions filed from 1996 through 2007 ended in settlement.

[36]Talley (2006) found a rate of 6.55 percent, while Park (2013) found that 7.6 percent of securities class actions filed from 1996–2004 resulted in a settlement by a gatekeeper.

[37]Marino and Marino (1994) reported an average settlement of $9.46 million. Carleton et al. (1996) reported an average settlement of $11 million. Talley (2006) reported an average settlement of $13 million.

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Figure 1: Auditor contributions to largest 200 securities class action settlements (1996–2007).



NOTE: This figure reports the percentage of the largest 200 settlements in securities class actions filed from 1996 to 2007 where the auditor also settled the case.

largest overall settlements for cases filed from 1996 through 2007.[38] There is a significant drop-off with respect to the next 100 largest settlements. About a fifth of those settlements had an auditor contribution, averaging $12 million, an amount similar to that found by some of the earlier studies.

Unsurprisingly, these auditor settlements were associated with accounting restatements and bankruptcies. Table 1 describes the characteristics of the 65 auditor contributions to the Largest 200 Settlements. Despite the efforts to narrow Rule 10b-5 liability, about half the auditor settlements only asserted Rule 10b-5 claims. More than 80 percent of these auditor settlements were in cases where the issuer restated its financial statements. More than a third of the auditor contributions were in cases where the defendant company filed for bankruptcy. In such cases, plaintiffs have greater incentive to target third-party defendants such as auditors because the bankrupt issuer is usually prohibited by the bankruptcy stay from contributing to the settlement. More than 40 percent of the auditor settlements had a parallel investigation or action by the SEC, an indicator that the underlying case had merit.

Thus, at first glance, there is evidence that auditors are likely to contribute to settlements in cases involving the most severe frauds where an issuer pays a large settlement. Plaintiffs are able to recover against auditors in such cases even when they are

[38]The 81st largest settlement in the dataset was equal to $100 million.

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Table 1: Descriptive Statistics for Auditor Contributions to Largest 200 Settlements (1996–2007)

Variable	N	*% of Auditor Settlements*
Section 11	33	50.8
Bankruptcy	22	33.9
Restatement	53	81.5
SEC	28	43.1
Second Circuit	18	27.7
Ninth Circuit	13	20.0

NOTE: The table reports legal and nonlegal characteristics of the 65 auditor contributions to the largest 200 securities class action settlements.

proceeding solely under Rule 10b-5. Auditor liability may be determined not only by the legal cause of action available to the plaintiff, but also by the circumstances surrounding the fraud.

I then grouped the Largest 200 Settlements by auditor to compare the rates at which major auditing firms contributed to significant securities class actions. Arthur Andersen has often been singled out as a firm that was particularly lax in its audits because its significant consulting revenue created a conflict of interest with respect to its auditing business. For example, the district court in the Enron case referred to Andersen as a "repeat offender" with respect to "the most egregious cases of accounting fraud in history."[39] After studying a dataset of financial restatements, Professor Eisenberg and Macey concluded that Andersen was no worse than other major auditing firms with respect to the rate of restatements by auditing clients (Eisenberg & Macey 2004). The limitation of this finding is that not all restatements are equally serious. Even if Andersen had similar rates of restatements, it is possible that it had a higher rate of serious restatements than other firms.

Consistent with Eisenberg and Macey's findings, the auditor settlements with respect to these large frauds were distributed evenly among the major auditing firms. Each firm had between 11 and 13 settlements in the Largest 200 Settlements, with Andersen having 12.[40] As Figure 2 shows, Andersen was ranked third in average settlement amount.[41]

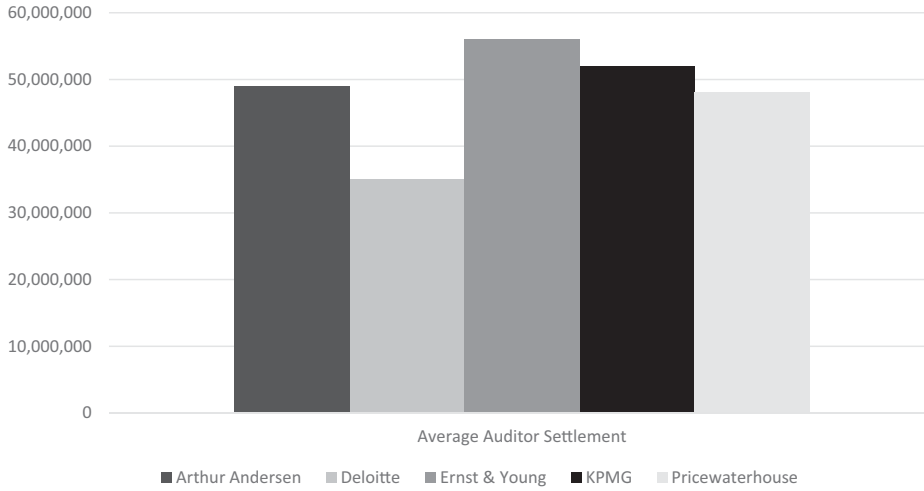
[39]See, e.g., *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp.2d at 675–76.

[40]See Appendix, Table A3. Because it went out of business after its indictment, Arthur Andersen no longer audited companies after 2002. Thus, there might have been a few more cases filed involving Andersen audits had it remained in business. However, because there is typically a lag of one or two years after the filing of financial statements and a securities class action, Andersen was a potential auditor defendant for all but one or two years of the dataset.

[41]With respect to median size of settlement, Andersen was second, but this median amount was similar to the median settlements of Deloitte and PWC. See Appendix, Table A3.

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Figure 2: Average settlement by auditor for largest 200 settlements (1996–1997).

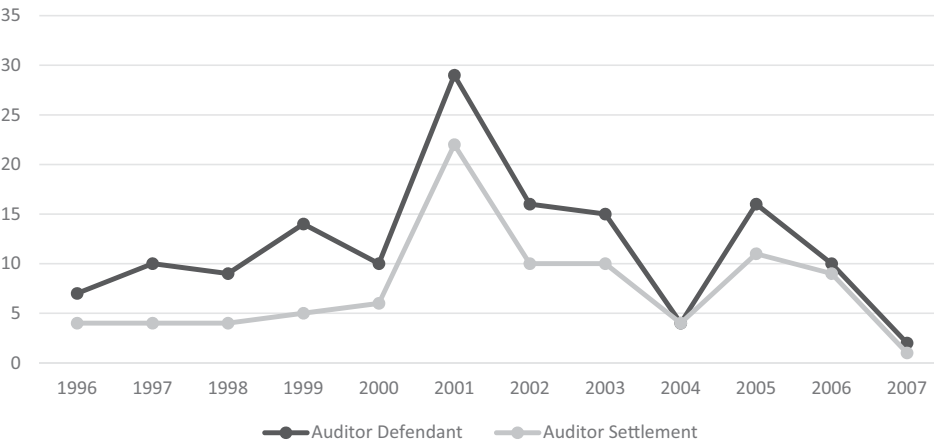


NOTE: The figure shows the average settlement paid by each of the Big Five accounting firms with respect to the largest 200 settlements.

2. Restatement Cases

The Restatement sample allows for a broader study of auditor litigation. Out of the 554 cases with an accounting restatement, 143, about a quarter, named an auditor as a

Figure 3: Auditor defendants and auditor settlements by year (restatements sample).



NOTE: This figure charts: (1) the number of securities class actions filed each year with an auditor defendant; and (2) the cases that ended with an auditor settlement.

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Table 2: Descriptive Statistics for Restatement Cases (1996–2007)

	All Restatement Cases (N = 554)		*Restatement Cases with Auditor Defendant (N = 143)*		*Restatement Cases with Auditor Settlement (N = 90)*	
Variable	N	*% of All Restatement Cases*	N	*% of Restatement Cases with Auditor Defendant*	N	*% of Restatement Cases with Auditor Settlement*
Auditor named	143	25.8	143	100.0	90	100.0
Auditor settlement	90	16.2	90	62.9	90	100.0
Pension fund lead	172	31.0	44	30.8	41	45.6
Section 11	97	17.5	49	34.2	39	43.3
Bankruptcy	96	17.3	45	31.5	32	35.6
SEC	169	30.5	61	42.7	34	37.8
2d Circuit	102	18.4	25	17.5	15	16.7
9th Circuit	154	27.8	30	21.0	20	22.2
10K restatement	381	68.8	126	88.1	83	92.2

NOTE: This table reports legal and nonvariables for: (1) all securities class actions with a restatement; (2) all restatement cases with an auditor defendant; and (3) all restatement cases with an auditor settlement.

defendant. When an auditor is named as a defendant in a restatement case, the case ends in settlement rather than dismissal more than half the time (a total of 90 auditor settlements). Thus, about 16 percent of the 554 Restatement cases end in an auditor settlement.

There do not appear to be any clear trends over the years covered by the dataset with respect to auditor settlements. There is no evidence that *Central Bank* and the PSLRA ever completely brought auditor contributions to a standstill. As shown by Figure 3, there is a spike in auditor defendants and settlements for cases filed in 2002. This trend does not persist in later years.

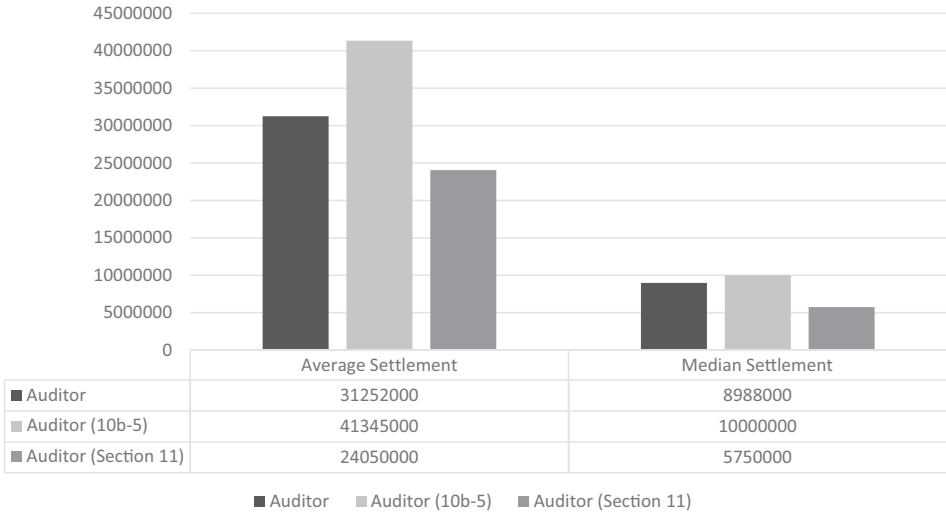
Table 2 summarizes data on the Restatement cases, as well as the subsamples of cases where an auditor was named as a defendant and the cases with an auditor settlement. The data include legal variables, such as whether the case was filed in the Second or Ninth Circuit, or whether the case asserted a Section 11 cause of action. It is notable that more than half the cases where an auditor was named as a defendant, and more than half the cases ending in an auditor settlement, only asserted claims under Rule 10b-5. The data also include variables that relate to whether the case is likely to have merit, such as whether there was an SEC investigation or action relating to the case, or whether a pension fund was the lead plaintiff. They also include variables relating to the size of the fraud, such as whether the issuer filed for bankruptcy, and whether the issuer's SEC Form 10-K was restated. It is notable that 92 percent of the cases ending in an auditor settlement involved a restatement of the 10-K.

Figure 4 compares the average and median auditor settlements for Rule 10b-5 and Section 11 cases.[42] Even with the more demanding liability standard, the average

[42]The average total settlement from all defendants was $366,000,000. The median total settlement from all defendants was $52,000,000.

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Figure 4: Average and median auditor settlements.



	Average Settlement	Median Settlement
Auditor	31252000	8988000
Auditor (10b-5)	41345000	10000000
Auditor (Section 11)	24050000	5750000

NOTE: This figure compares the average and median auditor settlements for cases: (1) alleging Section 11 claims; (2) cases alleging only Rule 10b-5 cases; and (3) all cases ending in an auditor settlement.

and median Rule 10b-5 auditor settlement was larger than the average and median Section 11 auditor settlement.[43] The analysis below will further test whether differing legal standards affect the size of the auditor's payment.

V. Analysis

This section presents the results of the study. Different primary liability standards do not affect the likelihood that a case names an auditor defendant or results in an auditor settlement. In contrast, the auditor scienter requirement is associated with modestly lower rates of auditor defendants and auditor settlements. For those cases where there is an auditor settlement, the auditor scienter requirement does not affect the size of the settlement.

A. *Hypotheses*

This section tests two hypotheses. As noted earlier, the law governing auditor liability differs in its stringency, allowing this study to test the effects of varying liability standards.

[43]This difference may reflect that in Section 11 cases, underwriters are often named as defendants and will also contribute significant amounts to the settlement. For example, most of the settlement amount in *Enron* and *WorldCom* came from the underwriters, who contributed an unusually high amount to those settlements. It might be that plaintiffs might not pursue auditors as aggressively in such cases. On the other hand, to the extent that there is financial fraud, the auditor would be primarily responsible for such fraud, and plaintiffs should have the incentive to seek substantial amounts from each defendant.

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First, the differing standards for primary liability between the Second and Ninth Circuit could affect the rate at which auditors are named as defendants, whether those cases result in an auditor settlement, and the size of such auditor settlement. The more stringent standard in the Second Circuit may lead to fewer auditor defendants and settlements, while the more lenient Ninth Circuit may lead to more auditor defendants and settlements.

It is important to note that selection bias should not affect this analysis. The primary liability standard is unlikely to affect the decision to file a case against the auditor in a particular jurisdiction. Auditors are almost always sued in the same forum as the issuer, and a prior study has shown that favorable legal standards do not affect the decision to file a case against the issuer in a particular jurisdiction (Cox et al. 2009). About 85 percent of the cases against the issuer are filed in the same jurisdiction as the issuer's headquarters.

Second, given the lenient standard of liability under Section 11, auditor defendants and auditor settlements should be more likely if a case asserts a Section 11 claim. When a case does settle, given the difficulty of winning a Rule 10b-5 claim, Section 11 settlements might be larger than settlements in cases solely asserting Rule 10b-5 claims.

B. Models

The legal standard is likely to affect a securities class action involving an accounting restatement at two stages. First, the plaintiff's assessment of the law may influence whether he decides to name an auditor as a defendant. Second, the law may influence the process by which a case is dismissed or settled for some amount. This section models the first decision with a logit regression, and the second decision with a hurdle regression.

1. Auditor Defendants

The decision to name an auditor as a defendant is made by the plaintiff, who will consider the likelihood of success of such a case. This decision can be modeled with a logit regression. The dependent variable is dichotomous and defined as 1 if the plaintiff names an auditor as a defendant, and 0 if the plaintiff does not name an auditor as a defendant.

The logit regression includes independent variables measuring differences in legal standards as well as the merit of the case. Legal variables include whether the case was filed in the Second or Ninth Circuit and whether the case had a Section 11 claim. Most of the variables measuring merit, such as whether a pension fund is the lead plaintiff, have been used by other studies (McShane et al. 2012; Park 2013). One variable specific to the context of auditor litigation is whether the restatement was severe enough to affect the company's annual 10-K filing.[44] The Auditor Defendants model is as follows:

[44]As a robustness check, unreported regressions included a variable that measured the number of quarters affected by the restatement. The results of this regression were similar to the reported regression results.

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$$\text{Prob(Auditor Defendant} = 1) = \alpha + \beta_{1i}\text{Second Circuit}_i + \beta_{2i}\text{Ninth Circuit}_i + \beta_{3i}\ \text{Section 11}_i + \beta_{4i}\ \text{Pension Lead}_i + \beta_{5i}\ \text{Bankrupt}_i + \beta_{6i}\ \text{SEC}_i + \beta_{7i}\text{10-K Restatement}_i + \beta_{8i}\ \text{Market Cap}_i + \beta_{9i}\ \text{Company Return}_i + \beta_{10i}\ \text{S\&P 500 Return}_i + \beta_{11i}\ \text{Class Period Length}_i + \text{Year Controls} + \text{Industry Controls} + \varepsilon_i$$

The results of the logit analysis are reported in Table 3. The first logit model includes just the legal and merit variables, while the second model includes additional variables such as year and industry controls. Because the circuit variables are not statistically significant, there is insufficient evidence to conclude that differences in circuit legal standards influence the decision to name an auditor as a defendant.[45]

However, if the case asserts a Section 11 claim, plaintiffs are more likely to name an auditor. The Section 11 variable is positive and significant at the 1 percent level for both regressions. The average marginal effect for the variable (for Model 2) is 0.19, indicating that for the average case, the presence of a Section 11 claim increases the likelihood an auditor defendant is named by 19 percent. It is notable, though, that the magnitude of this effect is less than for some of the other variables. For example, the variable measuring whether the issuer was in bankruptcy is also positive and statistically significant at the 1 percent level. It has a higher coefficient than the Section 11 variable, and a higher average marginal effect of 0.21 (for Model 2).

The variable measuring whether there was a restatement of the issuer's 10-K was also positive and statistically significant at the 1 percent level for both regressions. As noted earlier, financial misstatements of a 10-K are directly attributable to the auditor in all circuits. Thus, an auditor would not be able to argue for dismissal on the grounds that it does not have primary liability for the misstatement. This result may explain the lack of statistical significance for the circuit variables. If plaintiffs tend to name auditor defendants in cases with frauds affecting the 10-k where primary liability is not an issue, the different Second and Ninth Circuit tests are less likely to impact which cases have an auditor defendant.

2. Auditor Settlements

The next model examines settlements for those cases where an auditor was named as a defendant. The decision to settle a case involves the plaintiff, the defendant, and the court. The settlement process can be divided into two related decisions. In the first, the case against the auditor is either dismissed, or it survives dismissal and settles. In the second, the parties determine the amount of the settlement for those cases that settle.

This process can be modeled using a hurdle model.[46] The hurdle model combines a selection model, which estimates the variables that determine whether the case

[45]In addition to the reported regressions, I estimated regressions with a variable controlling for all circuits that clearly had an attribution standard (the Second, Tenth, and Eleventh Circuits). The results were consistent with the regressions that only controlled for the Second Circuit.

[46]This model was proposed by Cragg (1971).

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Table 3: Logit Model of Auditor Named as Defendant

	Model 1	*Model 2*
Second Circuit	–0.552	–0.659
	(0.303)	(0.345)
Ninth Circuit	–0.400	–0.300
	(0.266)	(0.295)
Section 11	1.258**	1.448**
	(0.257)	(0.301)
Pension fund	0.479*	0.521
	(0.236)	(0.308)
Bankrupt	1.528**	1.580**
	(0.277)	(0.322)
SEC	0.406	0.366
	(0.230)	(0.278)
10-K restatement	1.626**	1.631**
	(0.317)	(0.365)
Market cap		0.107
		(0.073)
Company return		0.055
		(0.117)
S&P 500 return		–0.313
		(0.599)
Class period length		0.044**
		(0.009)
Year controls	No	Yes
Industry controls	No	Yes
Constant	–3.014	–8.078
	(0.341)	(5.246)
N	554	554
Pseudo R^2	0.174	0.284

NOTE: Logit regressions reporting standard errors in parentheses. Dependent variable is whether an auditor is named as a defendant in a securities class action. *, ** indicate significance at the 5 percent and 1 percent levels, respectively.

settles or not, with an outcome model, which estimates the variables that determine the amount of the settlement for those cases that settle. The selection variable is equal to 1 if the case ends in an auditor settlement, and 0 if the case does not. The outcome model is a linear model with the log of the size of the auditor settlement as the dependent variable. As with the Auditor Defendants model, both models include independent variables relating to legal standard, merit, year, and industry. They also control for the particular auditing firm that was the defendant. The two models are as follows:

(1) $\text{Prob(Auditor Settlement} = 1) = \alpha + \beta_{1i}\text{Second Circuit}_i + \beta_{2i}\text{Ninth Circuit}_i + \beta_{3i}\text{Section } 11_i + \beta_{4i}\text{ Pension Lead}_i + \beta_{5i}\text{ Bankrupt}_i + \beta_{6i}\text{ SEC}_i + \beta_{7i}\text{10-K Restatement}_i + \beta_{8i}\text{ Market Cap}_i + \beta_{9i}\text{ Company Return}_i + \beta_{10i}\text{ S\&P 500 Return}_i + \beta_{11i}\text{ Class Period Length}_i + \text{Year Controls} + \text{Industry Controls} + \text{Auditor Controls} + \varepsilon_i$

(2) $\ln(\text{Size of Auditor Settlement}) = \alpha + \beta_{1i}\text{Second Circuit}_i + \beta_{2i}\text{Ninth Circuit}_i + \beta_{3i}\text{ Section } 11_i + \beta_{4i}\text{ Pension Lead}_i + \beta_{5i}\text{ Bankrupt}_i + \beta_{6i}\text{ SEC}_i + \beta_{7i}\text{10-K Restatement}_i + \beta_{8i}$

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Table 4: Hurdle Regression of Auditor Settlements

	Selection Model	*Outcome Model*
	Auditor Settlement	*Log Auditor Settlement Size*
Second Circuit	–0.370	0.052
	(0.456)	(0.388)
Ninth Circuit	0.255	–0.302
	(0.395)	(0.378)
Section 11	0.881**	0.340
	(0.347)	(0.317)
Pension fund	1.103	0.348
	(0.450)	(0.354)
Bankrupt	0.744*	0.936**
	(0.380)	(0.307)
SEC	–0.463	0.732*
	(0.340)	(0.329)
10-K restatement	1.418**	–0.227
	(0.480)	(.537)
Market cap	0.153	0.598**
	(0.085)	(0.084)
Company return	–0.232	0.412
	(0.213)	(0.293)
S&P 500 return	0.523	2.509**
	(0.773)	(.678)
Class period length	0.001	–0.008
	(0.012)	(0.010)
Year controls	Yes	Yes
Industry controls	Yes	Yes
Auditor controls	Yes	Yes
Constant	–1.495	2.598
	(90187.14)	(2.387)
N	143	143
Pseudo R^2	0.317	0.317

NOTE: Hurdle regression reporting standard errors in parentheses. The dependent variable of the selection model is whether a case with an auditor defendant ends with an auditor settlement. The dependent variable of the outcome model is the log of the auditor settlement size. *, ** indicate significance at the 5 percent and 1 percent levels, respectively.

$$\text{Market Cap}_i + \beta_{9i}\ \text{Company Return}_i + \beta_{10i}\ \text{S\&P 500 Return}_i + \beta_{11i}\ \text{Class Period Length}_i + \text{Year Controls} + \text{Industry Controls} + \text{Auditor Controls} + \varepsilon_i$$

The results for the selection model were similar to the results for the Auditor Defendants model. The circuit variables were not statistically significant, but the Section 11 variable was positive and statistically significant at the 1 percent level. However, the size of the Section 11 coefficient was smaller than for the Auditor Defendants regression, perhaps because auditor defendants were mostly named in the stronger Rule 10b-5 cases. This result differs from the Donelson and Prentice study, which found no statistically significant relationship between offerings and the rate of auditor settlements, or Section 11 claims and the rate of auditor settlements (Donelson & Prentice 2012:484, 485, 487). The bankruptcy and 10-K restatement variables were also positive and statistically significant.

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In contrast, in the outcome model, none of the legal variables affected the size of the auditor settlement. The circuit and Section 11 variables were not statistically significant.[47] Nonlegal considerations were the primary driver of auditor settlement size. For example, the bankruptcy and market cap variables were both positive and statistically significant at the 1 percent level.[48]

A demanding legal standard has the greatest impact at early stages of the case. Plaintiffs are somewhat less likely to name auditor defendants in Rule 10b-5 cases. When they do name auditors, it is somewhat more likely that these cases will be dismissed. However, the cases that name auditors and survive dismissal may be particularly strong, and result in similar settlements as Section 11 cases. Thus, the auditor scienter requirement screens but does not preclude auditor liability under Rule 10b-5.

VI. Courts and the Resilience of Auditor Liability

This section looks to case law to explain the results of this study. There is evidence that courts interpret narrow standards more leniently when they believe a case is strong. This tendency may explain why narrow auditor liability standards have not precluded liability.

A. Primary Liability

The lack of evidence that the more stringent standard for primary liability in the Second Circuit affects the likelihood or size of an auditor contribution may reflect the merit of auditor cases during this time period. Courts may be reluctant to dismiss what they believe to be a good claim. Moreover, cases involving a substantial accounting fraud are likely to satisfy even a stringent test for primary liability.

For example, in the *Global Crossing* case,[49] despite the Second Circuit's restrictive attribution rule, a federal district court judge in the Southern District of New York held in 2004 that an auditor could be liable for misstatements in "unaudited press releases and 'pro forma' disclosures" that did not explicitly identify the auditor as the maker of the statement.[50] Rather than apply a strict attribution test, the court reasoned that a defendant can be considered to have "made" a statement "even where the statement is not publicly attributed to the defendant" if "investors are sufficiently aware of defendant's participation that they may be found to have relied on it *as if* the statement had

[47]The SEC variable was positive and statistically significant at the 5 percent level, indicating that the presence of an SEC action or investigation was correlated with higher auditor settlements. However, the SEC is not subject to the legal limitations on Rule 10b-5 actions that affect private plaintiffs.

[48]These results can be contrasted with earlier studies finding that issuer settlements are lower in bankruptcy (Park 2013). The two sets of results are consistent. While the issuer is subject to the bankruptcy stay, auditors are not subject to the stay, thus the size of auditor settlements is not limited by the bankruptcy process.

[49]In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp.2d 319 (S.D.N.Y. 2004).

[50]*Id.* at 327.

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been attributed to the defendant."[51] Rather than requiring an explicit attribution by the auditor, the court's articulation of the law would allow for attribution based on auditor participation that was so substantial that investors knew of and relied on that participation, even if the document was not an official statement by the auditor.

Based on this broader standard for primary liability, the court found that the auditor "prepared, directed, and controlled" the false statements at issue.[52] Moreover, because investors knew that the auditor was involved with Global Crossing's more formal SEC filings, and had marketed the controversial accounting practices at issue, the unaudited financial statements could be attributed to the auditor. After the district court denied the motion to dismiss, the auditor settled the case for $25 million.

The *Global Crossing* decision is an example of a court aggressively reading the law to reach auditors when there is evidence of fraud and investors suffer substantial losses. Indeed, another district court and the Second Circuit in 2007 later rejected the *Global Crossing* court's interpretation of the attribution standard.[53] Before it was overturned, the result in *Global Crossing* could have influenced cases that settled based on the possibility that other Second Circuit courts would follow *Global Crossing*.[54]

Moreover, apart from sympathetic judges, for frauds that cover a significant time period, it is likely that the fraud will affect the audited financial statements included in the issuer's 10-K. Indeed, about 70 percent of the restatements in the Restatement dataset involved the 10-K. Since auditors sign off on those financial statements, they can be primary violators of the securities laws with respect to those reports. Thus, the lack of evidence that the Second Circuit's attribution standard impacted the resolution of cases might mean that primary liability is not a significant issue because restatements triggering a securities class action are likely to affect the 10-K.

In light of this study's findings, it is unlikely that the *Janus* standard, which will require all circuits to adopt the Second Circuit's attribution test, will completely foreclose auditor liability for significant frauds. The requirement that an auditor be a primary violator of Rule 10b-5 does not appear to affect the likelihood or size of an auditor settlement.

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[51]Id. at 333 (emphasis added).

[52]Id. at 334.

[53]See, e.g., In re Warnaco Group, Inc. Sec. Litig., 388 F. Supp.2d 307, 315 n.3 (S.D.N.Y. 2005) (questioning *Global Crossing* court's view that the Second Circuit was moving toward a "substantial participation" test); see also Lattanzio v. Deloitte & Touche, 476 F.3d 147 (2d Cir. 2007) (affirming *Warnaco* and reaffirming attribution test).

[54]It is important to note that judges in the Second Circuit were not always willing to find that auditors should be primary defendants in cases involving substantial fraud. In the securities class action against Marsh & McLennan, the district court in 2006 dismissed certain claims against Deloitte & Touche relating to unaudited portions of Marsh & McLennan's SEC filings. In re Marsh & McLennan Co., Inc. Sec. Litig., 501 F. Supp.2d 452, 478 (S.D.N.Y. 2006). It concluded that those sections were "not attributable" to Deloitte. Id. at 478. It is notable that there was no restatement of financial restatements in the *Marsh* case, perhaps indicating that there was not clear evidence of an accounting problem.

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B. Scienter and Rule 10b-5

Though it likely reduces the number of settlements, the high standard for finding that an auditor acted with scienter did not preclude auditor liability under Rule 10b-5, at least with respect to significant frauds. When auditor cases end in settlement, there is no statistically significant difference in the size of Rule 10b-5 auditor settlements. These results cast doubt on the conclusion that auditors are "insulated" from liability, at least with respect to securities class actions with strong merit.

These findings are best explained by evidence that courts flexibly apply the "red flags" standard for establishing scienter to allow for a remedy when they believe there is merit to the plaintiff's allegations of fraud. In many Rule 10b-5 auditor settlements in the sample, courts signaled a willingness to find that an auditor ignored "red flags" with respect to significant frauds, even when the "red flags" that could be identified were not particularly distinctive.

For example, in deciding the *Enron* case, the court pointed to a number of red flags, including the observation that Enron had an "unusually complex organization," in finding that a complaint adequately alleged scienter by Enron's auditor, Arthur Andersen.[55] The court in the *Cendant* case pointed to Ernst & Young's failure "to obtain direct evidence" and reliance "instead on the representations of management" as evidencing recklessness.[56] In the *Lernout* case, the court found an "array" of red flags, such as a lack of internal controls, in finding that the plaintiffs met their pleading burden against the auditor KPMG.[57] Similarly, in the securities class action against AOL-Time Warner's auditor Ernst & Young, the court found that the auditor "ignored several … complex barter transactions that generated gains or earnings growth ….."[58] In the *Refco* case, the court rejected an auditor's argument that the complaint did not allege scienter, pointing to the suspicious nature and "large size" of the fraudulent transactions at issue in the case.[59]

At least part of the willingness to find "red flags" can be explained by the prevalence of severe frauds during part of the period spanned by the dataset. In finding sufficient red flags to deny a motion to dismiss against an auditor, the judge in the *Global Crossing* case noted that "plaintiffs have alleged a fraud of a magnitude only rarely seen—at least until recent years."[60]

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[55] *In re Enron Corp. Sec., Deriv. & ERISA*, 235 F. Supp.2d at 677.

[56] In re Cendant Corp. Litig., 60 F. Supp.2d 354, 372 (D. N.J. 1999).

[57] *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp.2d at 165.

[58] In re AOL Time Warner, Inc. Sec. & "Erisa" Litig., 381 F. Supp.2d 192, 240 (S.D.N.Y. 2004).

[59] In re Refco, Inc. Sec. Litig., 503 F. Supp.2d 611, 657–60 (S.D.N.Y. 2007).

[60] *Global Crossing*, 322 F. Supp.2d at 347.

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The influential Southern District of New York loosened the standard governing auditor scienter in response to this wave of securities fraud. Courts in that district began explicitly considering the magnitude of a fraud as a factor in finding auditor scienter. As one district judge observed, "[a]llegations of particularly large frauds might go far toward creating a compelling inference of auditor scienter based on recklessness even where actual knowledge of the fraud by the defendant auditor is not alleged."[61]

These cases provide an explanation for the correlation between the size of auditor settlements and variables such as bankruptcy and the market capitalization of the issuer. These factors are proxies for frauds of greater size and impact where a court is more likely to find red flags and scienter. Knowing this, auditors will pay more to settle such cases.[62]

C. Judges and Liability Standards

This study finds evidence that judges interpret what seem to be restrictive liability standards broadly when faced with a significant fraud. This tendency can influence parties to settle such cases for substantial amounts. These findings suggest that the current legal framework provides auditors with an incentive to detect serious fraud.

These results should lead to questions about earlier arguments that judges will rely on simplistic heuristics to dismiss complex securities law cases. Professors Bainbridge and Gulati argued that judges are overworked, not particularly interested in securities law, and thus use heuristics to "move cases off the docket in an acceptable fashion" (Bainbridge & Gulati 2002:86). Professor Sale argued that the use of heuristics to dismiss securities class actions reflects disdain for the class action attorneys who bring what judges see as frivolous claims (Sale 2002).

As the results of this study show, something has changed since these scholars presented their pessimistic predictions about the behavior of judges. For one thing, the frauds have become more significant and serious. The time when scholars could say that "'high profile' and 'controversial' are almost never words used to describe securities class action cases" (Bainbridge & Gulati 2002:107) has passed. Though judges have many tools to dismiss auditors from cases, they instead have allowed strong cases against auditors to proceed past the motion to dismiss stage. Rather than taking the easy route of dismissal, many judges have written extensive, fact-intensive opinions relating to auditors and their misconduct. Although a judge's decision on a pretrial motion does not hold the same weight as that of a jury after a trial, the fact that a court allows a case to survive stringent liability standards sends a signal that a case was meritorious. In doing so, courts inform litigants and potential litigants they think that certain conduct is

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[61]In re IMAX Sec. Litig., 587 F. Supp.2d 471, 484–85 (S.D.N.Y. 2008); see also McIntire v. China Mediaexpress Holdings, Inc., 927 F. Supp.2d 105, 135 (S.D.N.Y. 2013) ("In the face of this alleged fraud, the Court finds it somewhat implausible for [the auditor defendant] to maintain that it conducted a rigorous audit … and was unable to uncover any evidence of fraud.").

[62]It is important to recognize that courts in this period did not always find that the auditor failed to detect red flags in cases involving a high-profile fraud. See, e.g., *In re Marsh & McClennan Co., Sec. Lit.*, 501 F. Supp.2d at 489 (dismissing Deloitte for failure to sufficiently allege scienter).

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problematic, leading defendants to settle similar cases. The frequency of substantial auditor settlements in the largest securities class actions no doubt is the result of the efforts of courts to hold auditors liable for their failure to prevent the worst frauds.

Moreover, judges do not always use heuristics to dismiss cases, but also use heuristics to determine which cases should proceed past the motion to dismiss stage. An earlier study presented evidence that the bankruptcy of the issuer is a heuristic that judges use in assessing whether a case has merit (Park 2013). This study provides additional support for those findings. In assessing the liability of auditors for securities fraud, courts will tend to allow cases to continue based on whether there was a significant accounting fraud by the issuer.

Judges could be criticized for stretching the law for severe frauds. The tendency for judges to believe that auditor scienter is more likely with respect to large frauds might reflect hindsight bias. On the other hand, these decisions might reflect the considered judgment of judges who are experts in assessing factual allegations.

Thus, even though the law on the books appears to preclude liability, the similar size of Section 11 and Rule 10b-5 settlements is evidence that judges are in fact applying what is close to a strict liability standard for auditor Rule 10b-5 cases involving significant frauds. If one were to accept the conclusions of Professors Coffee, Partnoy, and Hamdani that some form of strict liability is the appropriate standard for auditor liability, the current system may not be so far from such a standard with respect to substantial frauds.

The size of the settlements paid by auditors uncovered by this study may lead some to conclude that further limitation of auditor liability is necessary. However, while auditors are often liable for serious frauds, they are not liable for every case where there is an accounting mistake. Only a quarter of cases involving an accounting restatement even name an auditor as a defendant, and only 16 percent of cases with an accounting restatement end in an auditor settlement. Auditors are rarely held liable for the entire amount of the settlement, and their aggregate contribution to securities class action settlements is relatively small. Even without the caps to auditor liability proposed by Professors Partnoy and Coffee, the system, which relies heavily on private settlements to set damages, has effectively limited the extent of auditor liability for securities fraud.

Despite the survival of auditor liability for securities fraud, there still may be problems with the narrowing of auditor liability. It is likely that some auditors who are complicit in securities fraud escape liability, especially when a case involves a smaller accounting fraud. Such a result, though, may be the best compromise in a world where the reduction of litigation costs is a policy concern. Defending the securities class action on policy grounds may require accepting limits that still allow the strongest cases to survive.

One implication of this study is that efforts to narrow liability may reduce the overall number of settlements while allowing settlements in the most serious cases. After the Supreme Court's decision in *Halliburton v. Erica John Fund*,[63] it is likely that fraud-

[63]134 S. Ct. 2398 (2014).

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on-the-market class actions under Rule 10b-5 will remain as a viable cause of action for some time. There may be a case for continuing to manage the costs of such suits. If so, one possible approach would be to raise the standard of liability. For example, the test for determining whether a misstatement is material could be made more demanding. Based on this study, the likely effect of such a reform would not be to eliminate Rule 10b-5 liability, but to reduce the number of cases resulting in liability while allowing for the most serious cases of fraud to move forward.

VII. Conclusion

Despite exceptional efforts by courts to restrict the liability of auditors for securities fraud, it appears that for substantial securities frauds, auditors typically contribute sizeable amounts to the settlement fund. Moreover, differing liability standards for auditors do not always appear to affect the likelihood or size of an auditor settlement. There is no evidence that the elimination of aiding and abetting liability as a theory has shielded auditors from responsibility for severe frauds. There is evidence that the auditor scienter standard modestly affects the decision to name auditors as defendants and whether a case with an auditor results in a settlement. The liability standard does not affect the size of the settlement, which is driven by factors such as the bankruptcy and market capitalization of the issuer. It is thus difficult to conclude that narrowing the scope of Rule 10b-5 has precluded substantial liability for auditors.

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Appendix

Table A1: Variable Definitions

Variable	*Definition*
Second Circuit	Variable = 1 if the suit was filed in a district in the U.S. Court of Appeals for the Second Circuit.
Ninth Circuit	Variable = 1 if the suit was filed in a district in the U.S. Court of Appeals for the Ninth Circuit.
Section 11	Variable = 1 if the complaint alleges a violation of Section 11 of the Securities Act of 1933.
Bankruptcy	Variable = 1 if the issuer was in bankruptcy during the pendency of the securities class action.
SEC	Variable = 1 if there is an SEC action relating to the subject matter of the complaint.
Pension fund	Variable = 1 if a pension fund is named as lead plaintiff.
Restatement of 10-K	Variable =1 if the restatement covers the issuer's 10-K.
Market cap	Log of market value of the equity of the issuer on the first day of the class period.
Class return	The issuer's stock return measured from the start of the class period to the end of the class period.
S&P 500 return	Return on the S&P 500 index measured from the start of the class period to the end.
Class length	Length of the class period measured in months.

Note: Definitions of legal and nonlegal variables for the study.

Table A2: Largest Auditor Settlements (Cases Filed from 1996–2007)

Issuer	*Auditor Settlement*	*Auditor*
Cendant	335,000,000	E&Y
Tyco	225,000,000	PWC
Adelphia	210,000,000	Deloitte
HealthSouth	142,500,000	E&Y
Rite Aid	125,000,000	KPMG
Lernout	115,000,000	KPMG
Enron	112,500,000	Andersen
Sunbeam	110,000,000	Andersen
Waste Management	107,000,000	Andersen
WorldCom	103,000,000	Andersen
AOL Time Warner	100,000,000	E&Y

Note: Size and identity of auditor paying the settlement for the largest auditor settlements.

Table A3: Auditor Settlements by Auditor (Largest 200 Settlements)

Auditor	*Auditor Settlements*	*Average Settlement*	*Median Settlement*
Arthur Andersen	12	48,766,667	27,500,000
Deloitte	13	35,343,077	24,000,000
Ernst & Young	13	55,550,000	13,000,000
KPMG	13	51,769,115	44,750,000
PricewaterhouseCoopers	11	47,536,364	24,500,000

Note: Average and median auditor settlements organized by auditor paying the settlement.

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